COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

AN INQUIRY INTO INTER- AND INTRALATA INTRASTATE COMPETITION IN TOLL AND RELATED SERVICES MARKETS IN KENTUCKY	))))	ADMINISTRATIVE CASE NO. 273

O R D E R

INTRODUCTION

Prior to January 1, 1983, and the divestiture of the Bell system, intrastate long distance service was provided by South Central Bell Telephone Company ("SCB") in conjunction with the independent local telephone companies. The tariffs for this service were approved by the Kentucky Public Service Commission ("Commission") on application by SCB with the other companies concurring in (agreeing to) uniform statewide toll tariffs. The toll revenues were divided between SCB and the other telephone companies using an intricate process known as settlements. A similar procedure was utilized in distributing interstate long distance revenues, with the exception that American Telephone and Telegraph Company ("AT&T") was involved in the process. The revenues were divided between AT&T and SCB based on separations factors with settlements remaining applicable to independent companies. Effective January 1, 1983, SCB was restricted to providing intrastate long distance service within each of the three

separately defined geographic areas known as Local Access Transport Areas ("LATAs") (intraLATA service). American Telephone and Telegraph Communications ("ATTCOM"), a subsidiary of the divested AT&T, was assigned ownership of SCB's facilities in Kentucky for the provision of long distance service between LATAs (interLATA service). The Commission, in Case No. 8935, The Application of AT&T Communications of the South Central States, Inc., for a Certificate of Public Convenience and Necessity to Provide Telephone Common Carrier Service, both granted authority to ATTCOM to begin providing interLATA long distance service in Kentucky, and established the rates for such service. Currently intraLATA service is being provided, as it always has been, by SCB and the independent local operating companies.

The changing industry structure in conjunction with radical changes in pricing of services and revenue distribution necessitates a thorough re-examination of some of the Commission's basic regulatory policies. The primary issue in this proceeding is whether the Commission should grant authority to other carriers to compete with ATTCOM for interLATA toll traffic and with SCB and independent telephone companies for intraLATA toll traffic. The implications for all facets of the telecommunications industry and the consuming public are far-reaching.

PROCEDURAL BACKGROUND

On January 10, 1984, the Kentucky Public Service Commission issued an Order establishing this case. All telephone utilities and Wide Area Telecommunications Service ("WATS") Resellers regulated by the Commission were made parties to the proceedings

and hearings were scheduled for March 7, 1984. Each telephone utility and WATS Reseller was ordered to prefile testimony addressing specific issues of concern to the Commission on various aspects of toll competition both within and between LATAs. Furthermore, the Commission incorporated the record from Case No. 8873, An Investigation into the Effects of Competition Upon Local and Toll Exchange Service Including the Issues of Intra- and InterLATA Competition, Access Charges and Bypass, and Methods of Regulating Competitive Markets, into this case.

Motions to intervene were filed by MCI Telecommunications Corporation ("MCI"), Western Union Telegraph Company ("Western Union"), Allnet Communications Service, Inc. ("Allnet"), the Attorney General's Office ("AG"), Multi-Com Systems, Inc., ("Multi-Com"), GTE Sprint Communications Corporation ("GTE Sprint"), and Long Distance Telephone Savers, Inc. These motions were granted without exception.

Public hearings were conducted at the Commission's offices in Frankfort, Kentucky, on March 7, 1984, for purposes of cross-examining witnesses. Briefs were filed on April 6 and 13, 1984. All information requested during the hearings has been filed.

The need to address the Motion of ALLTELL Kentucky, Inc., to strike a pleading filed by Telamarketing and Multi-Com is made moot by that pleading having been withdrawn by letter dated May 3, 1984.

Witnesses appearing for the telephone utilities and WATS resellers were as follows:

ATTCOM:

Robert D. Willig, Professor of Economics and Public Affairs, Princeton University

Oliver W. Porter, Vice President--Sales for the Southern Region of ATTCOM

SCB:

E. Blair Mohon, Assistant Vice President--Revenue Requirements for SCB

Cincinnati Bell Telephone Company ("Cincinnati Bell"):

John H. Prickett, General Manager--Economic Analysis

General Telephone of Kentucky ("General"):

Larry Sparrow, Vice President--Revenue Requirements for General Telephone of the Southeast and General Telephone of Kentucky

Continental Telephone of Kentucky ("Continental"):

Earle A. MacKenzie, General Accounting Manager

Witnesses providing testimony on behalf of intervenors were as follows:

MCI:

David Shaffer, Senior Manager, Operations Technical Support

Michael D. Pelcovits, Economist; Cornell, Pelcovits & Brenner Economists, Inc.

Multi-Com:

Jeffrey Zahner, Executive Vice President, Multi-Com Systems

AG:

Ben Johnson, President, Ben Johnson Associates, Inc.

LEGAL ISSUES

The major legal issues that must be resolved prior to a decision on the merits in this proceeding are:

(1) Does the Commission have the power to authorize intrastate toll competition in Kentucky?

(2) Can the Commission impose different requirements upon competitors, if competition is allowed?

Kentucky case law recognizes that existing utilities have no absolute right to be free of competition.[1] The U. S. Supreme Court has previously held that states may, after initial grant, subsequently authorize others to begin operations in the same field without giving rise to a valid basis for complaint.[2] In fact, KRS 278.510(2) strongly indicates that the legislature favored competition in the provision of toll services in Kentucky. That provision requires a showing that no substantial public benefits result from the separate existence of toll

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[1]KU v. Public Service Commission, Ky., 390 S.W.2d 168, 175 (1965).

[2]Tennessee Electric Power Co. v. TVA, 306 U. S. 118, 83 L.Ed. 543, 550 (1939).

providers and that actual competitive conditions do not exist before mergers could be approved by the Commission.

The standard for obtaining a certificate of public convenience and necessity requires a determination that a proposal is feasible and will not result in wasteful duplication.[3] "Duplication" has been interpreted to encompass the concept of excessive investment in relation to productivity or efficiency. As discussed in greater specificity in subsequent sections of this Order, concerns regarding duplication of facilities among toll carriers which are not providing local exchange facilities need not necessarily be resolved by this Commission since it can be presumed that those firms will only invest when their own economic analyses dictate that is the appropriate course. Should that judgment later be shown to be in error, there will be no opportunity for ratepayer cross-subsidy; rather, the consequences will be borne by the firm's stockholders. The Federal Communications Commission ("FCC") has reached similar conclusions.[4]

Accordingly, the Commission concludes that it has the power to authorize intrastate toll competition in Kentucky.

With respect to the Commission's ability to impose different requirements upon competitors, there is ample precedent to support such treatment. In American Airlines v. CAB, 359 F.2d 624, 627 (D.C. Cir.), cert. denied, 385 U. S. 843 (1966), Judge

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[3]KU v. PSC, Ky., 390 S.W.2d 168, 175 (1965).

[4]American Satellite Corporation, 55 F.C.C.2d 1 (1975) and United States Transmission Systems, 66 F.C.C.2d 1091 (1977).

Leventhal determined that reasonable distinctions between groups of carriers were permissible. This Commission has a history of treating firms differently in its regulatory requirements where the facts so justify. For example, pursuant to KRS 278.220, the Commission has established a uniform system of accounts by industry, with further classifications based upon revenues. Likewise, the Commission has adopted a streamlined rate relief procedure which is available to small utilities with 400 or fewer customers or $200,000 in gross operating revenues.[5]

In the instant case, there is ample justification for differentiating between carriers in the intrastate interLATA market where one carrier currently commands at least 90 percent of that market in addition to significant other advantages. Such vast differences warrant the Commission's designation of carriers as "dominant" or "nondominant" and applying appropriate rules for each. The FCC and other state regulators have recently taken this course.[6] Accordingly, the Commission concludes that it may impose different requirements upon competing carriers, since a rational basis for such distinction exists.

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[5] 807 KAR 5:076.

[6] Competitive Common Carrier Rulemaking, 85 F.C.C.2d 1 (1980); Consummating Order, Docket No. 830118-TP, Order No. 12472 (1982); In re Petition of MCI Telecommunications Corp. for a Certificate of Public Convenience and Necessity, Docket No. 920450-TP, Order No. 12292 (1983); and Grant of Petition of Southern Pacific Comm. Corp. for a Certificate of Public Convenience and Necessity, NYPSC Case No. 28418 (1983).

INTERLATA COMPETITION

With the exception of the Independent Group,[7] all parties to this proceeding support the introduction of competition in the intrastate interLATA toll market in Kentucky. Moreover, several companies assert that it would be extremely difficult for this Commission to prevent the Other Common Carriers ("OCCs") (i.e., all facilities-based long distance carriers other than ATTCOM and local exchange companies) from offering intrastate interLATA service.

The positions of the parties supporting interLATA competition are, in general, similar to those expressed in the following quotes:

> Competition should be allowed by the Commission. The telecommunications industry is already subject to much competition and regulatory goals should be directed toward the orderly implementation of competition and deregulation.[8]

> This Commission probably cannot, regardless of its desire, resist the trend of decreasing regulation and increasing competition that is occurring in the telecommunications industry in this country. ...intrastate interLATA competition is inevitable and our efforts should now be directed to making the transition as smooth as possible.[9]

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[7] Independent Group: Ballard Rural Telephone Coop., Duo County Telephone Coop., Foothills Rural Telephone Coop., Harold Telephone Company, Highland Telephone Coop., Leslie County Telephone Company, Lewisport Telephone Company, Logan Telephone Coop., Mountain Rural Telephone Coop., North Central Telephone Coop., Peoples Rural Telephone Coop., Salem Telephone Company, South Central Rural Telephone Coop., Thacker-Grigsby Telephone Company, West Kentucky Rural Telephone Coop.

[8] Response of SCB to Staff Request dated January 10, 1984, p. 12.

[9] Response of Cincinnati Bell to Staff Request dated January 10, 1984, p. 2.

The benefits of competition in interexchange telecommunications were also enumerated by many of the parties in this docket. These benefits were summarized by Dr. Ben Johnson:

> There are several potential advantages to permitting competition in this segment of the industry: increased economic efficiency, increased equity, increased technological innovation, expanded market choices or consumer sovereignty, and decreased long-run costs.
>
> There is also a related benefit of permitting competition in the intercity market: if these markets become truly competitive, regulators will be relieved of the task of attempting to simulate the results of competition; instead, these results will follow directly.[10]

While the Commission agrees competition potentially confers these benefits upon society, it is true that only effective and workable competition that is sustainable in the long run offers these benefits. The mere presence of several firms in a market is not sufficient indication that competition is effective. Thus, the Commission is in agreement with Dr. Johnson when he states,

> Economists attribute all of these potential advantages to purely competitive markets; thus, they will be achieved only to the extent that effective competition develops in particular markets or submarkets -- they will not automatically result by simply permitting competitive entry, without regard for the type of transition which occurs.[11]

In order to make a proper determination concerning inter-LATA competition and other issues confronting the Commission in this docket, it is necessary for the Commission to assess the current state of competition in interstate toll markets as well

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[10] Testimony of Dr. Ben Johnson, p. 12.

[11] Ibid.

as the most likely course of development of intrastate toll competition. Many parties contend that competition exists in interstate toll telecommunications markets, and can therefore exist in intrastate markets if the Commission would so authorize. However, the question facing the Commission is not simply whether some degree of competition can exist in intrastate toll: the fundamental question is whether competition can function in such a manner that it is in the public interest to allow it.

For reasons discussed below, the Commission is of the opinion that it is somewhat premature to conclude that competition in the interstate toll market has proven itself to be an effective and viable regulator of that market. Parties urging the Commission to allow intrastate competition rely in large measure upon precisely this conclusion to support their contentions that intrastate competition would be in the public interest. Nevertheless, it is apparent to the Commission that there has been an expansion in both market choices and technological innovation as a result of a pro-competitive regulatory policy. Therefore, the Commission is of the opinion and finds that the limited experience with toll competition in the interstate market does support the adoption of a similar policy for the interLATA market in Kentucky. It is an appropriate first step in implementing competitive toll telecommunications markets in Kentucky. This finding includes the following interexchange services: Message Telecommunications Service ("MTS"), WATS and Private Line Services.

In making this determination, the Commission is not unmindful of the concerns of the Independent Group that,

> . . .[intrastate] competition will cause local service rates to increase to an unacceptable level. This could well place basic telephone service out of the reach of many Kentuckians, especially in the rural areas.[12]

This Commission is vitally interested in ensuring that the goal of universal service not be threatened by the introduction of toll competition. The Commission has taken actions in this docket and will take actions in other dockets necessary to prevent the adverse effects envisioned by the Independent Group.

While there was near unanimity among the participants concerning the desirability of interLATA competition, the specifics of the regulatory framework within which competition should operate were vigorously contested issues. These will be addressed in subsequent sections of this Order.

INTRALATA COMPETITION

Several of the parties urged the Commission to allow statewide (i.e., interLATA and intraLATA) competition at this time. This position was advanced by MCI, Western Union, Multi-Com, ATTCOM, GTE Sprint and SCB.

MCI contended that prohibiting intraLATA competition will deny consumers the general benefits of competition in this market. ATTCOM concurred in this opinion, and stated that the benefits forgone by such a decision would include increased

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[12]Response of Independent Telephone Group to Staff Request dated February 16, 1984, Item 4, p. 3.

innovation, wider customer choice, and better service. ATTCOM also emphasized that, irrespective of the Commission's decision on this question, some level of competition will occur, particularly in the form of bypass technologies. SCB cited difficulties the Commission would experience in attempting to enforce a ban on intraLATA competition. In SCB's view, these difficulties strongly militate against a Commission decision to prohibit intraLATA competition.

Among the parties favoring either a temporary or permanent ban on intraLATA competition were Alltel, the Independent Group, Continental, General, Cincinnati Bell, and the AG. The Independent Group believes that intraLATA competition would result in higher local exchange rates and higher toll rates on low density, high cost routes, which are often rural. Alltel agrees with this assessment, and pointed out its opinion that few intraLATA routes can reasonably be expected to support viable competition. Both these parties argue there currently exists a subsidy from intraLATA toll to local exchange which should be maintained indefinitely by banning intraLATA competition.

General, Continental, Cincinnati Bell, and the AG favor a temporary moratorium on intraLATA competition. In general, these parties argue such a moratorium will allow exchange carriers to realign prices and otherwise prepare for competition at the same time it would provide the Commission and the exchange companies time to evaluate the development of competition in the interLATA market. Continental further argues this will allow the revenue streams of the exchange carriers time to stabilize. Cincinnati

Bell testified that a moratorium would allow the local carriers time to gain experience in filing toll tariffs and cited possible advantages of deferring the introduction of intraLATA competition until equal access is generally available to all inter-exchange carriers.

Dr. Johnson advanced several additional reasons for deferral. Among other things, deferral would permit the Commission to implement a system of access charges on a more limited basis, while existing intraLATA contractual arrangements could be retained. This would simplify that process and allow experience gained in the interLATA arena to be applied to the intraLATA market at a later date.

Although many parties have argued interexchange competition is a reality, there has been insufficient experience to date for the Commission to conclude that long-run, sustainable competition exists in the interstate market and is transferable to the intrastate intraLATA market. The evolution of competition in this industry is still effectively in its infancy. Until a comprehensive system of access charges or some alternative is implemented, in conjunction with the equal access provisions of the Modified Final Judgment ("MFJ"), this Commission cannot know if the OCCs can effectively compete with ATTCOM. Their success to date may be due to the OCCs' newer technology and lower costs--as argued by MCI--or it may be attributable to receiving "subsidized" exchange access through the Exchange Network Facility Interconnection Agreement ("ENFIA") tariff. The Commission is of the opinion that the results of the current "experiment" will not

be known until the implementation of equal access at the very earliest. While the Commission anticipates competition will prove capable of successfully regulating this market, prudence dictates the Commission pursue a moderate course of action in the face of significant uncertainty.

The Commission is concerned that overzealous experimentation, resulting in precipitous changes in the institutional structures regulating telecommunication, can create unacceptable levels of economic dislocation. This economic dislocation can threaten both the Commission's goal of universal service and the financial viability of some telephone companies. These costs, both social and private, will be borne disproportionately by geographic regions and customer groups within Kentucky. It is the Commission's responsibility to manage the transition from monopoly to competition in a manner which will both decrease the probability of unnecessary economic dislocation and ensure that transition occurs at minimum costs to all regions and groups. A deferral of intraLATA competition will reduce the risks inherent in this transition by providing the Commission an opportunity to examine the combined effects of competition and the access charge structure in both interstate and intrastate interLATA toll.

Furthermore, a deferral of intraLATA competition will also afford the Commission the opportunity to better evaluate the "cream skimming" controversy. Existing regulated telecommunications carriers have traditionally argued that competitive entrants operate only on high volume low cost routes where regulation imposed rate averaging holds prices well above costs,

leaving the high cost, low or negative profit routes to the existing carrier. The OCCs and resellers dispute this and argue that simple sound business practice dictates that new entrants initially concentrate on high volume markets. They contend that over time, they will expand to serve increasingly less dense routes. The Commission will watch the development of the inter-LATA market with interest in this regard.

The Commission is of the opinion that the concerns expressed by the Independent Group, cited in part on page 8 of this Order, are justified as they apply to intraLATA toll. On the average, the smaller independent telephone companies receive in the range of 50 percent of their total revenues from toll; therefore, the Commission can foresee the possibility of substantial adverse impact upon these companies resulting from intraLATA competition. This impact would involve not only the level of revenues received by these companies statewide, but the distribution of these revenues between independents. The Commission does not have sufficient information to proceed on the assumption that intraLATA access charge revenues would approach the current levels of toll contributions, even in light of any toll traffic stimulation that might be presumed to occur as a result of competition. There is significant uncertainty concerning the impact of competition on the smaller exchange carriers, and permitting intraLATA competition at this time would expose these exchange carriers and their subscribers to undue risk of precipitous increases in rates for basic exchange service.

Moreover, the Commission is of the opinion that fundamental characteristics of the intraLATA toll market differ significantly from interLATA toll. Most importantly, the interLATA market contains a relatively high proportion of long haul high density routes, while the intraLATA market contains a higher proportion of short haul lower density routes. Experience clearly indicates that, up to this point, OCCs predominately locate facilities along and serve high volume toll routes. It therefore follows that more intraLATA routes would be served solely by one carrier for longer periods of time than interLATA routes even if intraLATA competition were allowed. This fact is explicitly conceded by GTE Sprint:

> . . .the microwave transmission facilities generally utilized by OCCs are not the most efficient for use on most intraLATA routes. Thus, significant short term penetration of the intraLATA market by the OCCs appears unlikely.[13]

In light of these facts, the Commission is of the opinion that significant public benefits will not be lost as a result of deferring the introduction of intraLATA competition.

Therefore, the Commission is of the opinion and finds that deferral of intraLATA competition is in the public interest. The Commission does not deny that there may be potential long-run benefits to intraLATA competition; however, the Commission is firmly convinced that in the shortrun the potential loss of benefits from competition is small relative to the risk to local

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[13]Response of GTE Sprint to Commission Order dated March 13, 1984, p. 8.

telephone service from immediate implementation of intraLATA competition. By gradually phasing in competition first at the interLATA level and then at the intraLATA level the Commission believes that the appropriate balance between the short-run concerns and long-run benefits will be struck.

Several actions taken by the Commission should serve to alleviate the short-run negative consequences of disallowing intraLATA competition at this time. Most importantly, WATS resellers will continue to have authority to operate statewide. The Commission expects resellers to increasingly bring the benefits of competition to the intraLATA toll market. Their presence should serve to minimize any benefits lost due to the deferral of facilities-based competition in intraLATA markets. The Commission also believes that a delay of intraLATA competition will not unduly encourage bypass, since the largest potential bypassers will undoubtedly be aware this is a temporary condition.

The Commission intends to monitor the evolution and growth in the OCCs' market share, transmission service routes, transmission capacity and number of competitors in the interLATA market to assist it in determining the effectiveness of competition as a regulator. Evidence from the development of this market will aid the Commission in determining when the introduction of intraLATA competition is warranted.

Unauthorized IntraLATA Calling

The existence of competition in the interLATA market at the same time it is not permitted in intraLATA toll presents the problem of unauthorized use of OCC facilities to complete intra-

LATA calls. Alternative policies to deter such use range from very lenient to quite stringent. The Commission solicited comments on this issue and received both pre-filed testimony and testimony at hearing addressing the problem and possible solutions.

MCI, Multi-Com, Telamarketing, Allnet, Western Union, and GTE Sprint favor an approach relying on control of OCC advertising and customer contact. InterLATA carriers either would simply refrain from presenting themselves to customers as intraLATA carriers or would affirmatively educate the public concerning the LATA concept and their lack of certification to carry intraLATA traffic. ATTCOM, Cincinnati Bell and Alltel favor the imposition of penalties or fines on OCCs for the completion or encouragement of intraLATA traffic. Cincinnati Bell would allow self-policing, while Allnet and ATTCOM favor some system of mandatory auditing or reporting. Continental and General favor requiring the physical blocking of intraLATA calls. The Independent Group supports physical blocking of calls, combined with cautionary advertising.

The Commission finds none of these proposed solutions to be totally satisfactory. In the Commission's view, requiring the physical blocking of calls would be inappropriate. Aside from any questions of feasibility, the weight of the evidence indicates this solution would impose inordinate costs upon the OCCs. These costs are not justified in light of the existence of alternative approaches that substantially alleviate the problem. A solution employing fees or penalties of some type is deficient in that an interLATA carrier could be penalized for the actions of

customers over which, absent a solution equivalent to total call blocking, the interLATA carrier has no control. It is true these carriers could have significant influence on customer behavior through vigorous informational and advertising efforts, and a system of penalties would undoubtedly encourage such efforts. However, based upon the record heretofore presented, it is simply not tenable for the Commission to penalize one entity for the undesirable actions of another. Further, if the penalties were placed on customers, they could have a significant adverse effect upon emerging competition. It is vital that the entrants to the interLATA toll market develop and maintain good relations with customers and potential customers, if they are to become effective competitors. Penalties of this type would unduly hamper efforts by new entrants to do so.

The Commission questions whether a program relying solely upon promotional and billing activities to inform and educate customers would be a sufficient deterrent to the completion of intraLATA calls over interLATA carrier networks. The interLATA rates charged by the OCCs will unquestionably be low enough that sizeable incentives may exist for customers to utilize OCC facilities for intraLATA calling. However, the Commission finds that, if properly augmented, this solution will constitute adequate deterrence at least cost to all parties. Therefore, the Commission will require each OCC to affirmatively advertise, through its billing and promotional materials, that it is not certificated to carry intraLATA calls. Additionally, the Commission will require that any completed intraLATA calls be billed

at the prevailing intraLATA tariff of the established carrier, and that OCC customer bills specify that any intraLATA calls completed will be billed at a rate equal to the certificated intraLATA carrier. This should effectively remove incentives for customers to place intraLATA calls over OCC networks, particularly in light of the possible inferior transmission quality of the OCCs and the extra dialing required to complete calls via the OCCs.

Due to ATTCOM's unique circumstances, it is not necessary for the Commission to apply these provisions to ATTCOM to accomplish the goal of preventing the unauthorized use of ATTCOM's facilities for intraLATA calling. However, it is the opinion of the Commission that it would cause undue customer misconception and confusion if the OCCs were required to advertise their lack of authorization to carry intraLATA traffic at the same time ATTCOM was exempt from this obligation. Accordingly, ATTOCM will be required to advertise that it is not certified to carry intraLATA traffic.

The Commission recognizes there are several problems associated with this solution to the problem. It will impose some costs upon the OCCs to accommodate this approach in their billing procedures. Additionally, the lack of automatic number identification on the line side connections utilized by the OCCs raises the possibility that some interLATA calling will be classified as intraLATA. However, as noted by the Independent Group, in almost all cases where this would occur an OCC customer would be placing a toll call to access the OCC switch in order to complete the

call over the OCC network. OCC customers would seem to have little or no incentive to place calls in this manner; therefore, the Commission agrees with the Independent Group that the incidence of this type of calling will be minimal.

The Commission will monitor the effectiveness of this solution, taking into account the impact of changing circumstances. In particular, the Commission recognizes that if this approach does not minimize intraLATA calling over OCC facilities, it could result in significant intraLATA revenues to these firms. If the Commission determines this approach is not sufficiently effective, it will be appropriately modified or replaced with an alternate solution.

DOMINANT-NONDOMINANT CARRIER CLASSIFICATION

The Commission sought comments from the parties to this docket regarding the desirability of instituting a dominant-nondominant carrier classification scheme similar to that adopted by the FCC, under the assumption some degree of intrastate toll competition were permitted. The underlying purpose of such a categorization is to recognize the differing nature and circumstances of various telecommunications carriers, and to enable implementation of differing regulatory treatment of carriers in recognition of their differing positions in the toll market.

Any determination to apply differential regulatory treatment to companies within an industry must be grounded in a determination that the public welfare is increased by such action. This will occur when the social costs avoided by according eligible utilities less stringent regulatory treatment outweigh the

social benefits that are realized by maintaining the full array of conventional regulation. Therefore, the fundamental question confronting the Commission in this issue concerns the relative sizes of these costs and benefits.

Some of the additional costs associated with increasing levels of regulation can be identified and quantified. Among these are the direct costs of various types of filings, of conducting cost studies, etc. However, the more significant social costs, such as adverse effects on innovation, are not amenable to measurement and quantification. Similarly, the benefits of stringent regulation can be identified, but not quantified. Put very simply, these benefits lie in controlling the abuse of monopoly power. In any market, the exercise of monopoly power essentially involves maintaining prices that diverge significantly from costs. Due to the coexistence of monopolistic and competitive market segments in the modern telecommunications industry, monopoly power in one segment can also be used to engage in anti-competitive practice in more competitive segments.

Two facts are immediately clear from this discussion. First, a decision on this issue necessarily entails the exercise of judgment; no amount of investigation will yield an unequivocal answer. Second, the desirability of relaxing regulation on any particular carrier or category of carriers hinges on the degree of monopoly power held by such carriers. If market power is not wielded by a carrier, there is no justification for full conventional regulation. Similarly, if differential degrees of market power are held by individual carriers, differential degrees and

forms of regulation are justified and in the public interest. Therefore, this section will focus largely on issues concerning market power.

The AG, GTE Sprint, MCI, Western Union, Telamarketing, Multi-Com, and Allnet advocate the use of dominant-nondominant classification and associated differing regulatory treatment. Arguments adduced in support of this position focus on the differential market shares and market positions of the carriers. These parties are all in essential agreement with Dr. Johnson, who states,

> The regulatory standards imposed on other facility-based carriers, such as MCI and GTE-Sprint, can be considerably less stringent [as opposed to those applied to ATTCOM], since they do not have the entrenched capacity or market dominance of AT&T and are thus less able to employ price discrimination or other anticompetitive strategies. . .[14]

MCI's witness, Dr. Pelcovits, stated,

> I further believe that the Commission should not impose the same kinds of regulatory requirements on new entrants that are and have been imposed upon carriers with substantial market power because such regulation would impose real costs on society with no obvious benefits to consumers.[15]

ATTCOM, Continental, Cincinnati Bell, General, SCB, Alltel, and the Independent Group oppose the implementation of such a structure. In general, these companies take positions similar to that of Continental:

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[14]Testimony of Dr. Ben Johnson, p. 45.

[15]T.E., March 8, 1984, p. 7.

> To require significantly more or less regulation of individual carriers . . .restricts true competition from taking place.[16]

For example, Alltel criticizes this approach as "not needed to encourage the development of competition. . ." and asserts that it ". . .would present a 'nondominant' carrier with significant competitive advantage."[17] The essence of the arguments advanced by these parties is that fair competition requires a "level playing field" for all competitors.

For the most part, the companies opposing dominant-nondominant carrier classification did not vigorously dispute the question of whether ATTCOM possesses monopoly power; in fact, several seem to concede ATTCOM potentially holds sufficient power to engage in anticompetitive behavior. For example, Cincinnati Bell states,

> It is understandable that there is fear that the dominant competitor will abuse its power, but anti-trust laws were designed to deal with this concern.[18]

Continental seems to implicitly acknowledge at least short term dominance of ATTCOM by recognizing the "superior market share and connections ATTCOM now enjoys."[19]

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[16] Ibid.

[17] Brief of Alltel in response to Appendix C of Commission Order dated March 13, 1984, p. 3.

[18] Cincinnati Bell response to staff request dated January 10, 1984, p. 3.

[19] Continental Telephone response to Staff Request dated January 10, 1984, p. 4.

ATTCOM was the only opponent of the classification scheme to substantively argue that no carrier in the Kentucky interLATA market currently has market power or will retain it in the near future. According to ATTCOM's witness, Dr. Willig, two conditions must be met for the existence of competition to ensure no carrier has market power:

> First, consumers must be willing to switch suppliers in response to price changes. And second, competing carriers must be willing to expand to meet the increased demand for their services that will be generated if another carrier raises its prices to an inefficiently high level.[20]

The Commission does not disagree with these statements, as far as they go. However, the Commission emphasizes that consumers must not only be willing, but must be able to switch suppliers, and competing carriers must not only be willing, but must be able to expand to meet increased demand. It is manifestly clear these conditions are not now met to a degree sufficient to guarantee that market power cannot be exercised by ATTCOM.

Three conditions currently must be met for consumers to be able to use alternative carriers. The OCC or reseller must serve the customer's area, the serving offices must have touch tone capability, and the customer must have a touch tone telephone, or its equivalent. These conditions are not currently met for a sizeable number of Kentucky's citizens. Even after implementation of the MFJ's equal access provisions and expansion by the

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[20]Testimony of Robert D. Willig, p. 14.

OCCs, there will undoubtedly be Kentucky residents who will have no alternative to ATTCOM for interLATA toll service.

With respect to the supply side, the fact that it will take the OCCs time to expand their capacity to meet increased demand would make it possible for ATTCOM to exercise market power for at least the near term. Although ATTCOM will undoubtedly face significant competition on selected high traffic density interLATA routes, the majority of intrastate interLATA routes will likely continue to be served by only one supplier. ATTCOM's position of monopoly on many routes will continue for some time, as it will be physically impossible for the OCCs to provide facilities-based service over anything but a small portion of the total interLATA routes in the near future. It takes time to acquire rights of way, acquire property on which to construct facilities, construct buildings, put up microwave towers and other facilities, and install switching and other equipment. There is no reason to expect the OCCs to be able to duplicate on a facilities basis in a short or even intermediate time period the interLATA toll network that has developed over considerable time under the existing monopoly structure of this industry in Kentucky. If full rate of return regulation of ATTCOM were lifted at this time, it would afford ATTCOM the opportunity to significantly raise prices and meet little or no competition on the bulk of its interLATA routes. It is obvious the Commission cannot expose the citizens of Kentucky to the potential abuse that could result from such a decision. It is simply incorrect to assert that ATTCOM does not possess significant market power

in interLATA toll in Kentucky at this time. Indeed, at present, ATTCOM is the only authorized interLATA carrier.

A careful reading of Dr. Willig's testimony reveals that he does not unequivocally assert that ATTCOM does not and will not possess, for some time, a degree of market power. This is illustrated by the following statement:

> As the MFJ takes hold, the strength of rivalry among active carriers and the real possibility of entry by new carriers should become sufficiently powerful to limit the existence of market power for any intrastate toll carrier. [Emphases added.][21]

ATTCOM's own witness thus apparently recognizes it will take time for an effectively competitive market to develop. It is also instructive that Dr. Willig places some importance on provisions of the MFJ. It should be recognized that the MFJ will be "taking hold" only over an extended time period, and will not be totally implemented before several years have elapsed.

The concept of market share typically figures prominently in any discussion of monopoly or market power. This measure has had a long history of development and utilization in both theoretical and applied economics. The FCC relied in part upon this concept in its determinations concerning dominant and nondominant firms and its findings that differing regulatory treatment should be accorded firms in these two categories. As pointed out in the brief of MCI and Western Union,

> The FCC also has held that market share is a primary indication of market power even where it is

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[21] Ibid.

not coupled with control over vertically integrated local exchange services.[22]

The brief goes on to state that,

> . . .the FCC determined that AT&T has market power in long distance telephone service because of its overwhelming share of the MTS/WATS market. This same degree of market power has been inherited by ATTCOM within Kentucky's market for interLATA service.[23]

Significantly, ATTCOM possesses virtually 100 percent of the interLATA toll market in Kentucky. The Commission takes note that in the area of anti-trust law, possession by a single firm of a market share of this size is sufficient to raise substantial questions concerning whether monopoly power exists. There is no evidence in this record to indicate ATTCOM's share to be anything other than between 90-100 percent, with the most reasonable estimate being toward the upper end of this range.

The parties opposing dominant-nondominant carrier classification did not, for the most part, address the issue of market share. The exception is Dr. Willig's testimony, wherein it is stated:

> A simple analysis of market shares conveys some information, but, contrary to what some have claimed, market share, by itself, is not a sufficient test. The market shares of alternative carriers are relevant only to the extent that they demonstrate that, if any carrier were to raise its prices, the remaining carriers would have the ability to raise their output significantly in response. A group of firms may have this ability even if their combined market share is low.[24]

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[22]Post-hearing brief of MCI and Western Union, p. 41.

[23]Ibid.

[24]Testimony of Robert D. Willig, p. 18.

Here, Dr. Willig points out the link between market shares as indicators of the strength of competition and the capacity of alternative carriers. However, he has failed to account for the fact that the OCCs as a group do not have and will not have in the immediate future sufficient installed capacity available to absorb a significant fraction of ATTCOM's interLATA intrastate customer traffic. If the OCCs had such capacity in place or could easily and quickly install it, then relative market shares would not be as central to an assessment of the structure of this market. However, this is not the case, and the Commission therefore finds arguments that market share is an irrelevant measure to be unpersuasive.

No argument was made by any party to this docket that the OCCs possess any degree of market power in interLATA toll. Although some "incidental" use of certain OCC networks to complete intrastate calling was conceded to occur, there was no representation by any party that the combined volume of all OCCs exceeded, for example, 10 percent of intrastate toll traffic. Moreover, on any interLATA interstate route an OCC elects to serve in the near future, ATTCOM will also be supplying service. It is apparent that, until a dramatic increase in the intrastate market share commanded by any particular OCC occurs, these carriers will not hold any monopoly power.

The Commission notes that applying different regulatory treatment to different companies within the same utility industry would not be a departure from past practice of this Commission.

The Commission has previously found it to be in the public interest to base differential treatment upon pertinent characteristics or criteria. The most notable example is the alternative rate filing procedure available to smaller utilities that meet certain requirements pursuant to 807 KAR 5:076.

The Commission recognizes that classifying interLATA carriers as either dominant or nondominant will confer certain advantages upon those determined to be nondominant. However, the Commission cannot fail to recognize the very substantial advantages ATTCOM possesses vis-a-vis the OCCs as a result of its historical position as the monopoly carrier. Among these significant competitive advantages are the virtually 100 percent market share ATTCOM now enjoys in the Kentucky interLATA market, the substantial goodwill and customer inertia resulting from years of being the sole carrier, the ubiquity of ATTCOM's interLATA toll offering, and superior access and interconnection to the local exchange networks. As a result of these and other advantages being possessed by a single carrier, the regulatory "level playing field" advocated by opponents of differential regulation would not be conducive to the development of effective competition. It is the opinion of the Commission that subjecting ATTCOM and the OCCs to differing regulatory treatment as envisioned herein will be an effective mechanism to promote the transition from monopoly to a workably competitive market.

The Commission emphasizes that dominant-nondominant carrier classification and differing regulatory treatment are transitional mechanisms. As access charges are implemented, equal

access provisions are met, and viable competition develops, these categories will need to be periodically re-evaluated. The Commission hopes that evolution of this market will render these classifications unnecessary in a reasonably short time period. It should also be emphasized that this decision has relevance only to the interLATA toll market. No inference should be drawn as to whether this might be a future course of action taken in the intraLATA market. The decision detailed in this Order regarding that market will stand until such time as a complete re-evaluation of the intraLATA situation is judged to be warranted. The course of events in the interLATA market will condition future actions taken concerning intraLATA toll.

WATS RESELLERS

In Administrative Case No. 261, An Inquiry into the Resale of Intrastate Wide Area Telecommunications Service, the Commission granted WATS resellers the authority to provide toll type service statewide. As a basis for granting statewide authority the Commission stated in its Order, ". . .the resale of WATS should provide a more efficient utilization of available system capacity which will benefit all customers." In this proceeding neither the telephone companies nor intervenors proposed to limit the statewide service authority granted to WATS resellers in Administrative Case No. 261. The AG's witness, Dr. Johnson, took the position that, by offering the proper regulatory environment to resellers, the Commission could facilitate the development of competition in the intercity market. The Commission concurs with Dr. Johnson's assessment and will therefore continue to permit

statewide resale of WATS. Accordingly, certain provisions of this Order pertaining to intraLATA competition and unauthorized intraLATA calling do not apply to WATS resellers.

REGULATORY REQUIREMENTS

The Commission has adopted a dominant-nondominant carrier distinction and has determined to regulate carriers, whether facilities or non-facilities based, according to this designation. Unless specifically identified, WATS resellers and facilities based OCCs will be considered nondominant carriers and subject to the regulations applicable to carriers so designated. The requirements set out in this Order will be monitored and revised whenever considered appropriate. The information required herein is to be provided on a Kentucky jurisdictional basis.

In addition to the above requirements, the company shall make all records available for scrutiny by authorized members of the Commission's staff or representatives for purposes of analyzing the development of the competitive market or other areas which fall within the scope of this Commission's authority. When it is mutually agreed that such information is proprietary in nature, said information shall be treated as being confidential and shall not be disclosed to any third party or made a part of any public record.

Dominant Carrier Regulation

All companies certified by this Commission as being dominant carriers for the purposes of providing competitive interLATA intrastate telecommunications services shall be subject to all regulatory requirements under KRS Chapter 278 and the

Commission's regulations, as promulgated in 807 KAR Chapter 5. The Commission deems this treatment to be necessary in order to fully evaluate the pricing and operating policies of the dominant carrier in determining the fair, just and reasonableness of the tariffs filed by the dominant carrier.

Nondominant Carrier Regulation

All companies certified by this Commission as being nondominant carriers for the purposes of providing competitive intrastate telecommunications services shall be subject to an abbreviated form of regulation relative to that applied to dominant carriers. The Commission is of the opinion that, due to their lack of market power, nondominant carriers will not be in a position to violate the fair, just and reasonable requirement of KRS 278.030. The Commission has further found that equal regulation of dominant and nondominant carriers would act as a barrier to entry and expansion of nondominant carriers, thus impeding the development of workable and effective competition. Therefore, the Commission will impose only that amount of regulation that it deems necessary to protect the customer and provide for orderly entrance of companies into the competitive market.

Any requirement of 807 KAR Chapter 5 not specifically addressed herein is generally waived as a requirement of this Commission for nondominant carriers subject to the continued monitoring and possible revision by this Commission.

Certification of Public Convenience and Necessity

In all applications for certification by nondominant carriers, public convenience and necessity will be assumed to

exist absent a showing to the contrary, with the burden of proof on an intervening party in opposition to certification.

The company filing for a certificate of convenience and necessity will be required to make a showing of financial viability which should include at a minimum a current (within 90 days of filing) income statement (if in operation), a balance sheet and pro forma Kentucky operating statements including the company's potential or forecasted demand and operations for its first 2 years of service. If the company is able to provide a showing of sufficient cash reserves or other financial backing, (i.e., line[s] of credit from a bank[s] or other financial institutions, etc.) to sustain the applicant through its initial operating period (2 years), the requirement to provide pro forma operating statements may be waived. The Commission is of the opinion that this requirement is necessary in order to limit the confusion generated in the marketplace by the appearance and rapid disappearance of companies offering services in what until recently was a stable monopoly environment. In addition to the above requirements, the applicant will be required to file its articles of incorporation, the address of its corporate headquarters, copies of its proposed tariffs showing its rates and charges and service conditions, and identify the areas it proposes to serve.

Application for Authority to Adjust Rates

The Commission will not require cost support documentation for nondominant carriers' tariff filings; however, the Commission reserves the right to require additional information it deems

appropriate. The nondominant carriers will be required to provide 20 days' notice to the public of the proposed tariff changes and to file a copy of their tariffs with this Commission. The proposed tariff changes will be adopted without suspension, since a nondominant competitive firm will be incapable of extracting charges that are unfair, unjust or unreasonable or unlawfully discriminatory. Absent a showing by an intervening party sufficient to justify a stay under the standard contained in Virginia Petroleum Jobbers Assn. v. FPC, 259 F.2d 921 (D.C. Cir. 1958), the Commission will not suspend the tariffs of nondominant carriers. The showing must include a demonstration that (1) there is a high probability that the tariff would be found to be unlawful after investigation (i.e., likelihood of success on the merits); (2) any harm alleged to competition would be more substantial than that to the public arising from the unavailability of the service pursuant to the rates and conditions proposed in the tariff filing (such as, a case where the proposed rate involves predatory pricing); (3) irreparable injury would be suffered if suspension does not issue; and (4) the suspension would not otherwise be contrary to the public interest. Of course, the motivations of intervenors will be a factor the Commission considers in evaluating any suspension petitions since competitors may have incentives to delay a carrier's proposal in their own self-interest.

Aside from the above-cited protections, the complaint procedures pursuant to KRS 278.260 are available. In addition, the Commission will monitor the nondominant carriers' tariff filings.

Reports

Nondominant carriers will be required to file on an annual basis an income statement, balance sheet, a statement of changes in financial position, a gross operating report and the number and type of customers being served, as well as the location and category of the company's investment in Kentucky. This latter information will be utilized by the Commission in assessing the development of the market structure, the changes taking place and the appropriateness of any changes to be made to the regulations applied to the competitive market. The nondominant carriers are not required to keep their financial records according to the system of accounts prescribed by this Commission, but must keep records in accordance with generally acceptable accounting requirements.

Customer Deposits

Any nondominant carrier which requires a customer deposit and/or advance payment for service is required to place these funds in an interest-bearing escrow account until the deposit is refunded or, if applicable, service billed in advance has been rendered. The company shall issue a written receipt of deposit to each customer from whom a deposit and/or advance payment is required showing the name of the customer, his address, date and amount of the deposit and/or advance payment and if applicable the time period the advance payment covers.

Discontinuance of Service

Nondominant carriers will be allowed to discontinue service after 30 days' notice to this Commission and proof that its

customers are notified, as long as alternative services are available.

Quality of Service Standards

The Commission's regulation, 807 KAR 5:061, contains several sections which define minimum standards for the quality of service offered by a telephone company. These standards were written with the expectation that one company would provide all telecommunications services, including basic local service and toll service, within its operating area. This will not be the case in the future; however, many of these standards as written are applicable to non-dominant interexchange carriers. Specifically, sections 19, 20, and 21(5) could be applied to all interexchange carriers.

The Commission finds that all nondominant interexchange carriers should conform to sections 19, 20, and 21(5) of 807 KAR 5:061. However, the Commission further finds that if a nondominant interexchange carrier wishes to offer a lower quality of service than that set out in 807 KAR 5:061, sections 19, 20, and 21(5), it should be allowed to do so under the following conditions: (1) the carrier should notify the Commission as to what the standards will be and how they will be determined, and (2) the carrier should notify its customers of the lower quality of service to be offered.

Findings and Orders

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that:

1. The Commission has the authority to authorize intrastate toll competition in Kentucky under KRS 278.510(2).

2. The Commission has the authority to impose different regulatory requirements upon competitive firms based upon the dominant or nondominant position of the firm in the marketplace.

3. ATTCOM, based on its historical monopoly position in interLATA communications, its interLATA share currently exceeding 90 percent and ability to exert monopoly power, is a dominant firm for regulatory purposes.

4. InterLATA telecommunications firms seeking initial certification which are without substantial market share and cannot exert monopoly pricing power are nondominant firms for regulatory purposes.

5. The potential benefits to the consumers from interLATA competition between telecommunications firms outweigh the costs and should be authorized.

6. The potential costs from intraLATA competition outweigh the potential benefits to the public in the short run and should be deferred.

7. Unauthorized intraLATA call completions cannot be blocked in a cost effective manner by interLATA telecommunications firms and inadvertent calls completed by interLATA firms should be priced at the same tariff rate as intraLATA toll calls completed by intraLATA firms.

IT IS THEREFORE ORDERED that a system classifying interexchange telecommunications carriers as dominant or nondominant be and it hereby is implemented.

IT IS FURTHER ORDERED that ATTCOM be and it hereby is designated a dominant carrier.

IT IS FURTHER ORDERED that interLATA carriers applying for initial certification be and they hereby are designated non-dominant carriers.

IT IS FURTHER ORDERED that interLATA competition between carriers be and it hereby is authorized.

IT IS FURTHER ORDERED that the authorization of intraLATA competition be and it hereby is deferred.

IT IS FURTHER ORDERED that each interLATA carrier not specifically authorized herein to carry intraLATA toll traffic shall provide this Commission a plan detailing how it will advertise this restriction to its customers and its potential customers, in addition to a copy of its promotional material incorporating that plan.

IT IS FURTHER ORDERED that every OCC not specifically authorized to handle intraLATA toll traffic shall bill its customers for intraLATA toll calls completed at the prevailing toll tariffs as filed or concurred in by the exchange carriers.

IT IS FURTHER ORDERED that WATS resellers can continue to provide service statewide.

IT IS FURTHER ORDERED that all carriers certified as being dominant for the purposes of providing competitive intrastate toll telecommunications services hereby continue to be subject to all regulatory requirements under KRS 278 as promulgated in 807 KAR, Chapter 5.

IT IS FURTHER ORDERED that all carriers certified as being nondominant for the purposes of providing competitive intrastate toll telecommunications services are hereby subject to the regulatory requirements of 807 KAR, Chapter 5, as abbreviated and modified by this Order.

IT IS FURTHER ORDERED that if a nondominant interexchange carrier elects to offer a lower quality of service than set out in 807 KAR 5:061 it shall notify the Commission as to what the standards will be and how they will be determined. The nondominant carrier shall also inform its customers or potential customers of this lower quality of service.

Done at Frankfort, Kentucky, this 25th day of May, 1984.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary